

## Internal Revenue Service

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In Re:

Department of the Treasury

Washington, DC 20224

Third Party Communication: None

Date of Communication: Not Applicable

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:FIP:4

PLR-155517-05

Date:

September 29, 2006

### LEGEND:

Company =

Agent =

Date A =

Date B =

Date C =

Year F =

State =

State law

E Association =

Number d =

M =

T =

U =

V =

W =

X =

Dear :

This is in reply to your letter of Date A, and subsequent correspondence of Dates B and C, in which you requested a ruling whether Company is permitted a deduction pursuant to section 832(f) under Subchapter L of the Internal Revenue Code of 1986, in the proposed transaction described below.

## FACTS

### **Company:**

Company is a State A domiciled captive reciprocal risk retention group that qualifies as an interinsurer (reciprocal) for Federal income tax purposes. Company was formed in Year F for the primary purposes of providing medical malpractice insurance for E Association. As a reciprocal risk retention group, Company operates as an unincorporated association of entities ("Subscribers") who acting through Agent, an attorney-in-fact, exchange insurance contracts, thereby insuring each other. Agent is a non-stock corporation.

Company files the National Association of Insurance Commissioners ("NAIC") approved annual statement for property and casualty insurance companies with the Department of Insurance for State A. Company provides claims-made professional liability and occurrence general liability coverage. Company is governed by its Board of Directors. The insurance contract among the Subscribers is the Subscriber's Agreement. It is under this agreement the Subscribers agree to insure each other. Pursuant to the Bylaws of Company, not less than three-fourths of the Board of Directors shall be subscriber-insureds of Company, and not more than one-fourth of the members of the Board of Directors may be agents or employees of Agent. The Board of Directors supervises the property, finances and operations of Company.

### **Subscribers:**

There are Number d Class I Subscribers. Under Company's Subscriber Agreement there are two classes of subscribers: 1) Class I Subscribers have

contributed capital to Company and are entitled to vote and are entitled to be credited subscriber savings; and 2) Class II Subscribers have not contributed capital to Company and are non-equity, non-voting subscribers. Class II Subscribers also include any insured that is insured solely through an extended period reporting endorsement. Each Class I Subscriber has one vote for each dollar in its accounts ("Capital Vote") and one vote as an individual subscriber ("Individual Subscriber Vote"). Under certain conditions, Class II Subscribers may petition Company to become Class I Subscribers. Under the Bylaws as incorporated in the Subscribers Agreement, the Board of Directors are elected by a plurality of Capital Votes cast by Class I Subscribers. All matters must receive both a majority of the Capital Votes and a majority of the Individual Subscriber Votes, unless a greater number of votes by the Class I Subscribers are required by law.

There are three Subscriber Statuses under the Subscribers Agreement:

- (1) A Subscriber remains so until it is no longer insured under an insurance policy;
- (2) A Discontinuing Subscriber is a Subscriber that is no longer insured under an insurance policy and such policies are subject to adjustment. A Discontinuing Subscriber also maintains the same voting rights as other Class I Subscribers; and
- (3) A Withdrawn Subscriber is a Discontinuing Subscriber that is no longer insured and all policy years which were subject to adjustment have been deemed final and closed by Company Board of Directors.

### **Capital Accounts and Rights of Subscribers:**

Company has established three types of capital accounts. The Charter Capital account is comprised of the initial capital contributions of Subscribers less their losses, if any, and any returns. Discontinuing and Withdrawn Subscribers are entitled to receive their Charter Capital Accounts, when capital returns are authorized by the Board of Directors.

The Subscriber Savings Account is comprised of calendar year savings (statutory income) of Company credited to each Subscriber. Credits to the Subscriber Savings Accounts are made at such times and in amounts determined by the Board of Directors and are calculated in accordance with the Subscriber Equity Allocation Plan, adopted by and amended from time to time, by the Board of Directors. The Subscriber Equity Plan may take into account such factors as the existing account balances, premium, losses, and reserves attributable to each Subscriber. Savings credited to the Subscriber Savings Accounts remain subject to absorption of future losses.

The Surplus Capital Account is comprised of capital voluntarily contributed to Company by Subscribers or capital otherwise credited on behalf of Subscribers. The Surplus Capital Account may be adjusted for any losses incurred by Company. Only after all Charter Capital Accounts have been distributed, return of capital, if authorized by the Board of Directors, may be made from the Surplus Capital Accounts.

Discontinuing Subscribers are eligible to share in the results of all policy years in which a policy was issued to the Discontinuing Subscriber and the Discontinuing Subscriber's

Surplus Capital account is subject to adjustment for those policy years. Once Charter Capital Account balances have been paid in full for the policy years at issue, and regular subscribers have been paid in full their Surplus Capital Accounts, the Discontinuing Subscriber will receive that portion of its Surplus Capital Account ratably over a ten-year period.

Pursuant to Bylaws of Company, in the event of voluntary termination or in the event of involuntary liquidation by State A Department of Insurance, the liabilities of Company will be satisfied or provided for as required by applicable law. If any surplus exists after payment of provision for all liabilities, such surplus will be distributed to its Subscribers who were the Subscribers of Company within twelve months prior to the last termination of its license. Each Subscriber's share of the distribution shall be an amount and in such proportion as shall be determined by the Board of Directors, or by State A Department of Insurance or a court having jurisdiction in the event a conservator or liquidator is appointed in the case of involuntary liquidation.

Under the Subscribers Agreement, each Subscriber agrees that the savings of Company may be credited to its Subscriber Savings Account in such amounts and such times as determined by the Company's Board of Directors. The amounts to be credited are calculated in accordance with the Subscriber Equity Allocation Plan as adopted and amended by the Board of Directors. A Subscriber Savings Account is maintained for each Subscriber. Company notifies Subscribers of amounts credited to their Subscriber Savings Account on or before March 15 following each tax year in which credits of statutory income are made. Notification of amounts credited to the Subscribers' Savings Account is sent to each Subscriber in accordance with section 1.823-6(c)(2)(v) of the regulations.

Company expects the majority of claims from a given policy year will be resolved within T. Most, if not all, claims will be resolved within U. Discontinuing Subscribers will be paid the amount reflected in their Subscribers Savings Accounts as follows:

- (1) Within 90 days of V of becoming a Discontinuing Subscriber, such Discontinuing Subscriber will receive M of the balance of its Subscriber Savings Account;
- (2) Within 90 days of W of becoming a Discontinuing Subscriber, such Discontinuing Subscriber shall receive M of the remaining balance of its Subscriber Savings Account; and
- (3) Within 90 days of X of becoming a Discontinuing Subscriber, such Discontinuing Subscriber will receive the remaining balance, if any, of its Subscriber Savings Account.

Subscribers shall be entitled to these distributions even if policy years for which they are responsible are still open and even if the Subscriber itself has open claims.

If at any time a Discontinuing Subscriber's Savings Account balance is greater than the amount by which its Subscribers Savings Account could be adjusted downward based on the results of claims from policy years still subject to adjustment, the Discontinuing Subscriber shall receive one or more payments from its Subscribers Savings Account so that at no time does a Discontinuing Subscribers Savings Account balance remain greater than the amount by which such balance could be subject to adjustment. Company will review a Discontinuing Subscribers Savings Account at least annually to determine if any payments will be made under this provision and will annually pay the Discontinuing Subscriber the excess amount.

Notwithstanding the above method and time parameters for returning a Discontinuing Subscribers Savings Account balance, a subscriber shall receive the entire amount reflected in its Subscribers Savings Account the earlier of (i) the time parameters listed above, or (ii) within ninety (90) days after becoming a Withdrawn Subscriber.

Additionally, the Agreement has a "true up" mechanism so that Subscribers receive the true balance of their Subscribers Savings Account once all policy periods in which they were a Subscriber are closed. Once a Discontinuing Subscriber becomes a Withdrawn Subscriber, the final true balance shall be determined. If the Withdrawn Subscriber balance is greater than the amounts that were paid to such subscriber, then Company shall pay the difference within 90 days following the Discontinuing Subscriber becoming a Withdrawn Subscriber. If a Discontinuing Subscriber or a Withdrawn Subscriber's true Subscriber Savings Account balance is less than the amounts that were paid to such Subscriber, then the Subscriber shall promptly repay Company the difference upon written notice by Company. If a Discontinuing Subscriber or a Withdrawn Subscriber has balances or credits reflected in any other equity accounts with Company or otherwise, Company may, at its option, require the Subscriber to repay the amount of overpayment to Company or deduct or offset the amounts against the other balances or credits.

### **Capital Contribution:**

The Agreement also provides that in order to remain financially strong by protecting the Subscriber insureds and Company from the unpredictable vicissitudes of this type of market, from time to time Company may request Subscribers with positive credit balances in their Subscriber Savings Accounts to voluntarily contribute as capital to Company distributions made to the Subscribers from their Subscriber Savings Accounts. These capital contributions are entirely voluntary. Subscribers are under no obligation to make a capital contribution. Each Subscriber determines whether or not it contributes, part, all or none of its Subscriber Savings Account distribution as capital to Company. No adverse action will be taken by Company against those Subscribers that do not contribute a portion or all of their Subscribers Savings Account credit balances. Company management will make the recommendation to the Board of Directors, which may accept, change, or reject the management recommendation. Board of Directors

may also act to approve a distribution without management recommendation. Once the Board of Directors approves the amount and time of the distribution, Company will, as required by State A law, seek any regulatory approvals from state authorities in order to make the Subscriber Savings Account distributions to Subscribers. Once required approvals are received from the Director of the State Department of Insurance, Company will allow Subscribers to make capital contributions by contributing some or all of their distributions to Company. Company represents that it is not issuing any financial instrument to Subscriber in return for the voluntary contribution and there is no requirement made by Company for Subscriber to agree to contribute capital in order to become a subscriber of Company. The purpose of the contribution is to maintain permanent capital. Company will distribute the Subscriber Savings Account distributions to Subscribers by transferring the savings credits out of their Subscribers Savings Account into their Surplus Capital Account as capital contributed on behalf of the Subscribers or by issuing a check to the Subscribers which in turn would issue capital contribution checks to Company. Company will track the Subscribers balance in the internal Surplus Capital account by policy year.

#### LAW and ANALYSIS

##### **Mutual insurance company as reciprocal:**

Section 7701 (a)(3) of the Internal Revenue Code defines the term "corporation" to include insurance companies.

Section 301.7701-1 (c) of the Income Tax Regulations provides that for purposes of taxation the classification of an organization is determined under the Internal Revenue Code rather than under state law. The term "corporation" is not limited to the artificial entity usually known as a corporation, but also includes an insurance company.

Rev. Rul. 83-132, 1983-2 C.B. 270 holds that a noncorporate business entity that is primarily engaged in the business of issuing insurance contracts is an insurance company, and therefore a corporation within the meaning of section 7701 (a)(3) of the Code, and thus is taxable as a corporation under the provisions of subchapter L.

Prior to 1987, mutual insurance companies were taxed under the provisions of sections 821-825. The Tax Reform Act of 1986 repealed these provisions and mutual insurance companies are now taxed under section 831 of the Code.

Section 831 of the Code provides that an insurance company other than a life insurance company is subject to tax at normal corporate rates on its insurance company taxable income.

Section 832 defines insurance company taxable income for purposes of the tax imposed by section 831 as the gross income of the insurance company as defined in section 832(b)(1), less the deductions allowed by section 832(c).

A distinguishing factor between a mutual insurer and a stock insurer is that the mutual insurer is controlled by and is operated for the benefit of policyholders. Neither the Code nor the regulations define mutual insurance company. The courts have determined that the characteristics of a mutual insurance company generally are: 1) the right of policyholders to be members to the exclusion of others and the right of such members to choose the management; 2) the sole business purpose is to supply insurance substantially at cost; 3) the right of members to the return of premiums in excess of those amounts needed to cover losses and expenses; and 4) common equitable ownership of the assets by the members. See Rev. Rul. 74-196, 1974-1 C.B. 140.

Current section 832(f) is a redesignation of section 823(b)(2) which was originally enacted by the Revenue Act of 1962. Revenue Act of 1962, Pub. L. 87-834, section 8(c), 1962-3 C.B. 111, 140. In considering the provisions of the Revenue Act of 1962, the Senate Finance Committee described an interinsurer or reciprocal underwriter as:

Reciprocal underwriters and interinsurers differ from ordinary mutual insurance companies in that their business is conducted by two entities rather one. An ordinary mutual insurance company receives all of the premium income from insurance and not only pays losses but conducts directly the operation and management of the insurance activities. The reciprocal underwriter or interinsurer, on the other hand, pays its insurance losses, but an "attorney-in-fact" performs all, or most, of the insurance functions-writing policies, collecting premiums, settling claims, keeping records, etc.-and pays the related expenses, for a portion of the premium income of the reciprocal.

S. Rep. No. 1881, 87<sup>th</sup> Cong., 2d Sess. 54 (1962), 1962-3 C.B. 707, 763.

Company is an unincorporated association through which Subscribers, acting through Agent, will exchange insurance contracts, thereby insuring each other. Company's only business is providing medical malpractice coverage substantially at cost. Subscriber remains a Subscriber until (1) the Subscriber is no longer insured and (2) all policy years subject to adjustment are deemed final and closed as determined by the Subscribers Agreement and by Company Board of Directors. Subscribers, through their right to vote, select the management and elect members of Committee. Subscribers also have the right to receive policyholder dividends to the extent declared and paid by Taxpayer and have the right to share in the assets of Taxpayer upon liquidation. Taxpayer will pay the insurance losses and A will perform the insurance functions.

### **Subscriber Savings Account :**

Section 832(f) provides that in computing the taxable income of an insurance company which is an interinsurer or reciprocal underwriter, the increase for the taxable year in savings credited to subscriber's accounts is allowed as a deduction, and the decrease for the taxable year in savings credited to subscriber accounts is includable as an item of gross income.

Section 832(f) defines the terms "savings credited to subscribers accounts " as the portion of the surplus for the taxable year that is credited to the individual accounts of subscribers before the 16<sup>th</sup> day of the third month following the end of the taxable year, but only if the reciprocal would be obligated to pay this amount promptly to the subscriber if he terminated his contract at the close of the taxpayer's taxable year.

### **Deduction for the increase in Subscribers Savings Account and an increase in income for the decrease in Subscribers Savings Account:**

Section 1.823-6(c)(2)(i) provides that with respect to interinsurers and reciprocal underwriters, a deduction is allowed for the increase for the taxable year in savings credited to subscriber accounts, or there is an inclusion as an item of gross income the decrease for the taxable year in savings credited to subscriber accounts.

Section 1.823-6(c)(2)(ii) provides that the deduction for savings credited to subscriber accounts may be claimed by a reciprocal only to the extent that the subscriber has a legally enforceable right to receive the amount credited to his account if he withdraws from the exchange, and where the amounts credited by the reciprocal to the individual accounts of its subscribers are actually paid to subscribers who terminate their insurance contracts during the taxable year. Thus, no deduction is allowed for savings credited to subscriber accounts if the savings are not in fact promptly returned to subscribers when they terminate their contracts.

Section 1.823-6(c)(2)(iii) provides that a reciprocal claiming a deduction under section 823(b)(2)(now section 832(f)) must establish and maintain an account for savings credited to subscriber accounts. The opening balance in such account for the first taxable year for which a deduction is claimed shall be zero and in each taxable year there shall be added to such account the total amount of savings credited to subscriber accounts for the taxable year (and there shall be subtracted from such account the total amount of savings subtracted from subscriber accounts for the taxable years). However, in no case may the amount added to the account exceed the total amount of "savings to subscribers for the taxable year", irrespective of the amount of savings credited to subscriber accounts by the reciprocal for that taxable year.

The regulations do not, however, define the term "savings to subscribers for the taxable year." According to the legislative history underlying section 823(b)(2), the special deduction for savings credited to subscribers accounts was intended to benefit "pure" or "classical" reciprocals which, as a matter of business practice, credited any



savings from insurance operations to the individual accounts of their subscribers on a yearly basis and which were, in fact, obligated to pay these savings to a subscriber if the subscriber was to terminate his insurance contract and withdraw from the exchange at the end of such year. See H.R. Conf. Rep. 2518, 87<sup>th</sup> Cong. 2d Sess. (1962), 1962-3 C.B. 401, 453.

Accordingly, the term "savings to subscribers for the taxable year" as used in section 1.823-6(c)(2)(iii) means that the portion of the company's surplus credited to subscribers which is attributable to current operating income, rather than amounts included in surplus for which the source of the funds was the individual subscriber (such as subscriber contributions to join the reciprocal) or prior earnings. See also 1.823-6(c)(2)(ii) (amounts contractually required to be returned to policyholders due to policy cancellations or erroneously computed premiums are not "savings credited to subscribers" within the meaning of former section 823(b)(2)). Moreover, since the portion of surplus that a "pure" or "classical" reciprocal could properly allocate to its individual subscribers would be based on the company's statutory income rather than taxable income, the term "savings to subscribers for the taxable year" refers to the statutory income as reported on company's NAIC annual statement.

Section 1.823-6(c)(2)(iii) provides that the increase, if any, in savings credited to subscriber accounts for the taxable year is generally the amount by which the balance in the account for savings credited to subscribers at the close of the current taxable year exceed the balance of such account at the close of the preceding taxable year; and the decrease, if any, for the taxable year in savings credited to subscriber is generally the amount by which the balance in the account for savings credited to subscriber accounts for the preceding taxable year exceed the balance of such account as of the close of the current taxable year.

Section 1.823-6(c)(2)(v) requires every reciprocal claiming a deduction under section 823(b)(2) (current section 832(f)) to mail to each subscriber written notification of the amount credited to his account for the taxable year, the date on which such amount was credited, and the date on which the subscriber's right to such amount first would be become fixed if such subscriber had terminated his contract at the close of the company's taxable year. This written notification must be mailed to every subscriber before the 16<sup>th</sup> day of the third month following the close of the reciprocal's taxable year.

Subscribers are not required to contribute distributions from their Subscribers' Savings Accounts in order to become members of the Company. No financial instrument is offered by Company to Subscribers in conjunction with the voluntary contribution of capital from Subscriber to Company. Under the terms of the Subscribers Agreement, Company is obligated to pay the Subscriber Savings Account balance promptly to its Subscribers upon termination of the Subscriber's Agreement.

**Savings credited to Subscribers Savings Account treated as dividends paid or declared and Deduction for policyholder dividends:**

Section 832(f) provides that the subscriber must treat the amounts representing savings credited to his account for a taxable year as a dividend paid or declared for purposes of computing the subscriber's taxable income.

Section 1.823-7 provides that a subscriber of a reciprocal underwriter or interinsurer entitled to the deduction allowed by section former section 832 (b)(2) and paragraph (c)(2) of section 1.823-6 shall treat amounts representing savings credit to its individual account for the taxable year as a dividend paid or declared for purposes of computing his taxable income.

Section 1.823-7 further provides that to the extent the insurance premium constituted a deductible expense when paid or accrued, the subscriber's taxable income for the taxable year will be increased and any loss for the taxable year will be decreased, by the amount credited to his account.

Section 832(c)(11) provides a deduction for dividends and similar distributions paid or declared to policyholders, in their capacity as such, in computing the taxable income of an insurance company, other than a mutual fire insurance company, subject to tax under section 831. The term "paid or declared" is construed according to the method of accounting regularly employed in keeping the books of the insurance company.

Section 1.832-5(a) of the regulations allows a deduction for policyholder dividends under section 832(c)(11). This section further provides that the deduction is the same as that allowed under former section 822(c)(6) to mutual insurance companies subject to the tax imposed by (now repealed) section 821. (Now section 831).

According to section 1.822-12, the term "dividends to policyholders" means dividends and similar distributions paid or declared to policyholders in their capacity as such, and includes amounts returned to policyholders where the amount is not fixed in the insurance contract but depends upon the experience of the company or the discretion of the management. This regulation also provides that savings credited to the individual accounts of the subscribers of a reciprocal are not considered policyholder dividends paid or declared within the meaning of the former section 822(f)(2). However, this regulation provides that actual distributions made by a reciprocal with respect to its subscriber account balances are treated as policyholder dividends under former section 822(c)(6) for the year paid.

Credits are made to Subscriber Savings Account in amounts as determined by the Board of Directors and are calculated in accordance with the Subscriber Equity Allocation Plan. Company will notify its subscribers of amounts credited to their

Subscriber Savings Account on or before March 15 following each tax year in which credits of statutory income are made. Notification of amounts credited to the Subscriber Savings Account will be sent to each Subscriber receiving a credit in accordance with section 1.823-6(c)(2)(v). Company's legal obligation to pay amounts credited to the Subscriber's Savings Accounts becomes fixed as of the close of the calendar year even though the actual crediting and notification to the Subscribers may take place after the close of the calendar year yet prior to March 15 of the following year. The portion of Taxpayer's income credited to Subscribers Savings Accounts will not exceed Taxpayer's NAIC net income for the year. In the event of termination of a Subscriber's insurance contract, the balance in its Subscribers Savings Account, will be paid promptly to the Subscriber in accordance with terms of the Agreement.

Holding:

Accordingly, based on the information submitted and representations made, it is held that Company is allowed a deduction pursuant to sections 832(f) and (c)(11) of the Code and corresponding regulations.

No opinion is expressed as to the tax treatment of the proposed transaction under any other provisions of the Code and regulations which may be applicable thereto, or the tax treatment of any effects resulting from the proposed transaction, which are not specifically set forth in this ruling letter. No opinion is expressed as to the tax treatment of the capital that is voluntarily contributed by Subscribers to Company.

A copy of this ruling should be attached to Taxpayer's federal income tax return for the taxable year of the proposed transaction.

This ruling letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

/s/

Donald J. Drees, Jr.  
Acting Chief, Branch 4  
Office of Associate Chief Counsel  
(Financial Institutions & Products)